

THE ECONOMY OF BULGARIA - July 2011

SUMMARY REPORT

Of the Center for Economic Development

The complete text of the report can be found at www.ced.bg, and www.manager.bg

MACROECONOMIC DYNAMICS. *The Bulgarian economy is definitely turning to growth, but it is weak and unsteady. **Approximately 2% growth** is expected **on an annual basis for the second quarter** of 2011. The contribution of industry (on the production side of GDP) in the formation of growth will also be complemented by the services. Net exports will continue to define growth on the use of GDP. Some acceleration of total economic growth is expected yoy in the third quarter. For the whole **2011** growth is expected to be in the range of **2.5-3%**.*¹

GDP started to grow on an annual basis since the second quarter of 2010, but for the whole year GDP growth is only 0.2%. For the first quarter of 2011 GDP grows by 1.5% on an annual basis, and value added in the economy grows by only 0.6%, growth to 1.5% is complemented, as in the previous two quarters, by the high growth (8%) in item "Adjustments."²

Two of the three sectors (construction, industry and agriculture), which sank most deeply in 2009 and turned to growth in 2010, record annual growth for the first quarter of 2011 – in *industry* (2.2%) and *agriculture* (0.5%) while *construction* again demonstrates decline (of 5.6%). In fact, growth in construction last year was only in the last quarter, and since it was too high (8.5%), it succeeded to bring the sector to the positive with 0.9% growth for the year.

The decline in "*Finance, credit and insurance; Real estate and business services*" in the first quarter of 2011 is disturbing. Its value added contracted by 2.7% on an annual basis, after demonstrating growth³ in both 2009 and 2010, and only in the two quarters – the fourth in 2009 and the first in 2010 - it registered drops on an annual basis.

With the release of annual data for 2010 two sectors seem problematic, i.e. declining on an annual basis, are "*Trade, repair of motor vehicles and household appliances; Hotels, hostels and catering; Transport and communications*" and "*Government; Education; Health; other services and NGO activities*." The good news is that for the first quarter of this year both sectors record growth on an annual basis correspondingly - by 3.9% and 1.8%.

The weak economic growth in early 2011 is seen in the dynamics of by use of GDP components. In the first quarter of this year (as in 2010 in general) the profile of economic growth (1.5% yoy) is

¹ Expectations are based on a series of seasonally not adjusted data, as published annual data are bound to the seasonally not adjusted quarterly data. More on this subject can be found in NSI methodological notes: "Measuring the effect of changes in volume and price changes" and in "Quarterly seasonally adjusted data." The dynamics (growth or decline) of all GDP components, discussed in this report, is in real terms, in contrast to the dynamics of components in the balance of payments and foreign trade, which is in nominal terms.

² Adjustments consist of taxes on products (excise, duties, VAT) less subsidies on products.

³ The seasonally not adjusted and adjusted data for this sector seem to be shockingly inconsistent: for the first quarter the value added on an annual basis shows decline in seasonally not adjusted data by 2.7% and growth in seasonally adjusted by 6.5%!!!

shaped on the use of GDP by a drop in *domestic demand*, thus resulting only from growth in *net external demand*.

Just as in 2010, when the weak growth on the use side was entirely due to *export* growth, so in the first quarter this year growth in exports of goods and services significantly outpaces imports (exports and imports of goods and services increase in real terms correspondingly by 24% and 8.6% yoy).

The still continuing in the first quarter of 2011 contraction in domestic demand on an annual basis is 1.6% in *final consumption* and 12.4% in *investments* (for the whole 2010 final consumption decreases by 1.1% and investments - by 16.5%). Individual consumption falls by 2.1% in first quarter (after a decline of 1.3% for the whole 2010).

It seems that services are joining the factors (growth in industry and exports) bringing for Bulgaria's recovery. This in turn may be related rather to services as intermediate consumption in production, and tourism-related services, than to services for households, whose incomes still limit final consumption. In the short term industry will continue to be the driver of growth in terms of the economy's sectoral structure, but in terms of demand - the contribution of net exports of goods and services will be complemented by discontinued drop in final consumption and in investments.

Monthly data for April and May 2011 show that for the second quarter slower growth is expected in value added in *industry* on an annual basis compared to the first quarter. This will involve slowing down in manufacturing. In *construction*, the decline in construction output increases until April, but declines in May and is expected to be lower in the second quarter than the first, which is the reason to expect contracting decline in value added in the sector. The new feature is that since the beginning of the year there is a stable change in the profile of the sector dynamics – the decrease in building construction is lower than that in civil engineering. In *trade* turnover positive dynamics is observed on an annual basis, due to high rates in automobiles trade, which have been positive since last November. *Wholesale*, however, has been close to zero since March. The dynamics of annual turnover in *retail trade* has been just above zero since March. Changes are noticed in the profile of retail turnover - since March dynamics in the sector is affected more by trade in non-food goods, while trade in foods declines on an annual basis. It can be expected that in the second quarter, as in the first one, the sector of *trade* will contribute to total growth with its growth in value added on an annual basis, which however, will still be weak.

Short-term data do not show signs for significant acceleration of overall economic growth in the second quarter, over the first quarter, which is more likely to happen in the third quarter.

After the **current account** deficit almost disappeared in 2010 (to 1% of GDP) in the first five months of 2011 the current account balance is positive. For the entire period January - May 2011 it amounts to Euro 412.4 million or 1.1% of GDP⁴ (at a deficit of 2.3% of GDP for the period a year before). Major factors in this dynamics are exports, and as a consequence – the lower trade deficit. Imports in nominal growth continue to lag behind exports. The positive balance in services is improving. The negative balance under Income is reduced. The net receipts from current transfers are almost identical to a year earlier. *The current account deficit for the whole 2011 is expected to be close to zero.*

⁴ With gross domestic product for 2011 – euro 38, 892 million (BNB estimates) and for 2010 (data from the NSI of 03/11/2011) – euro 36, 032.9 million.

The recovery of the world economy and especially – that in the eurozone is at the heart of the continuing dynamic development of **foreign trade**. The total value of *exports* (FOB) for the first five months reaches Euro 8.025 billion, rising in nominal terms by 47.2 per cent over the same period of 2010. *Imports* (CIF) grow at a slower pace (25.6 per cent) and reach Euro 8.885 billion. The difference in growth rates leads to a decrease in *trade deficit* (FOB/CIF) by almost half - from Euro 1.62 billion a year ago to Euro 0.86 billion in January-May 2011 (2.2 percent of projected GDP compared to 4.5 per cent a year ago). Undoubtedly, higher commodity, fuel and food prices affect the volume of trade turnover. The data indicate that the value of exports of raw materials and fuels grows twice as fast as imports, while for foods the increase is the same. This means that the accelerating increase of exports is not only due to prices, but also due to the continuing recovery of the industry. Exports are still dominated by products of low added value. This creates uncertainty about the future, since the market for these products is influenced strongly by international prices, the formation of which is beyond the influence of Bulgarian companies.

Increased international prices of raw materials and fuels are fundamental to the changes in the commodity structure of trade. Exports of fuels rise by almost twice in a year and those of raw materials - by 64 per cent, by which the share of these two groups of goods in total exports increases from 53.6 per cent to 60.7 per cent. Sales of investment goods maintain moderate growth, since there are no great changes in prices. In imports, the situation is the same, but growth rates are lower. So, trade in raw materials reaches a positive balance. Imports of finished products, including investment goods, grow moderately due to the still weak domestic demand and insufficient investment in production.

The major market is still the EU (60.7 per cent of total exports). Germany, Italy, Romania, Greece, Belgium continue to be major trading partners, but reduced consumption in Greece ranks it from second to fourth position among Bulgaria's major markets. Exports to Balkan countries grow by over 50 per cent and trade with them still forms a significant surplus. Turkey ranks second significant market after Germany. For the first five months of the year significant growth is registered in exports to countries such as India, China, USA.

Instead of FDI inflows in the first five months of the year there is withdrawal of funds from the country (Euro 26.9 million or 0.1 percent of GDP). This is due to payments on intercompany loans (Euro 373 million), while investments in equity (Euro 265.2 million) are by about 22 percent less than in the first five months of 2010. Reinvested earnings (Euro 80.8 million) are also by 20 percent less, but the last two values will show increase in subsequent revisions. It is clear that, in the still weak recovery of the national economy and contracted internal market, some foreign companies prefer directing available funds to pay off debts rather than to expand. Others simply postpone planned investments for better times. In general, funds are invested in already existing foreign-share companies. FDI inflow will remain weak in the coming years until new profitable sectors are identified, to replace the attractive ones so far – such as real estate, finance, services. *For 2011 FDI are not expected to exceed the volume of 2010 (Euro 1.6 billion), and may be even lower.*

The accumulated **inflation** by June, according to the Consumer Price Index (CPI), decreases to **1.7%** (after a maximum of 2.7% in April). The inflation according to the Harmonised Index of Consumer Prices (HICP) is usually lower – the cumulative by June 2011 compared to December 2010 is **1.1**. The increase according to the price index for the small basket (PISB) is still the highest since the beginning of the year (**2.5%** by June, after a peak of 4.5 in April).

After the sharp increase in food and fuel prices in January and February, which raised the expectations of the business for increase in the sales prices in construction, retail and services, the

expectations were unchanged till June for construction and services, but declined for retail; in industry the expectations for higher sales prices in the next three months increased significantly in May and still further - in June. Inflation expectations of consumers who have been growing since October last year, are continuing.

By the end of 2011 the still contracted final consumption, as well as the summer seasonal declines in the price of some foods, will restrict increase in general price levels, on the other hand the changes in international prices will most likely impact an increase, and they are difficult to predict. Available indications as of June give reason *to expect that accumulated inflation for 2011 in the country will not exceed the 4.5% of last year, if no sharp changes in fuel prices occur in the second half of the year.*

The decline of **employed in the economy** is slowing down on an annual basis (*according to National Accounts data*). For the first quarter this year the decline is 3.5%. The agricultural sector demonstrates lowest decrease in number of employed in the first quarter this year, and the sector "Finance, credit, insurance; Real estate and movable property, and business services" register growth in the number of employees.

For the first quarter the **economic activity rate of people in the age range 15 - 64** shows a weak deterioration (by 0.3 percentage points) over the same period last year and reaches 65.2% (*labour force survey data*), respectively, the employment rate drops to 57.3 %, while unemployment rises to 12.1%. According to preliminary data for the second quarter the economic activity rate is 65.6% (by 1.3 p.p. lower than a year earlier). Employment rate increases compared to the first quarter - to 58.2%, while unemployment decreases - to 11.3% but their rates are worse than those a year ago (respectively 60.2% and 10.1%). *Employment rate in the age range 20-64*, which is included in the strategy "Europe 2020," is by 2 points worse in the first quarter (to 62.6%) over a year ago, but its decline is diminishing (in 2010 it was 3.4 points compared to 2009).

From the positions of the unemployed participants in the labor market, the bottom of the crisis is neither 2009 nor 2010, as **quarterly unemployment rate** for the first and second quarters of 2011 continues to exceed the rates of previous years. The high rates come mostly from the younger age groups (15-24 and 24-34).

NSI business surveys until June show an uncertain decreasing trend in lay-offs in mid-2011. In the retail sector expectations for staff reduction are still close to zero, in construction expectations are for employment increase, in industry there are still expectations for staff reductions, although not worse, with greatest ranges in the expectations of the service sector. The latest (April) consumer survey shows increase, albeit slight, of concerns for unemployment.

Since June this year the Employment Agency has begun publishing **monthly unemployment rate** recalculated *with updated denominator - that is the total number of economically active population from the census in February 2011*. The previous denominator (from the previous census) was a number by 374,653 people higher than the present one. This change will "raise" unemployment rate (Fig.10). In June, employment offices registered 318,337 unemployed persons (10,196 persons less than in May and 24,672 less than in June 2010). With the 2011 denominator the unemployment rate for June is 9.56%. It improves by 0.31 p.p. over May and by 1.04 p.p. over May 2010.

The slow economic recovery will continue to delay stabilization on the labor market, which lags by about a year after general dynamics of the economy. Registered unemployment will remain high this year, but lower than last year. *It is expected to be at around 9.5% by the end of the year, lower in summer. According to NSI surveys quarterly unemployment will remain above 10%.*

ENTERPRISE POLICY. The overall economic environment in Bulgaria has not improved substantially - this is the conclusion of the European Commission in its assessment of July for the Convergence Programme 2011-2014, and the National Reform Programme 2012-2015. *The problems in the sectors of administration, education and the pension system* were identified as the most serious shortcomings. Staff reduction is not enough for serious reforms in the administration. There is lack stability, or measures for knowledge and skills improvement. The fight against corruption in regulatory bodies and institutions related to competition protection is not effective enough. This has a negative impact on the socio-economic development of the country and on absorption of EU funds. Besides the inefficient judicial system, important control bodies have insufficient capacity and fail to carry out effective control. Some specific examples provided by the EC are from the Public Financial Inspection Agency (PFIA) and the Public Procurement Agency (PPA). The Bulgarian economy is not creating the best environment for investment in such conditions, regardless of the low taxes. Administrative fees collected by institutions remain high, and permitting procedures are complicated.

In order to improve the investment environment *a draft Strategy for attracting investment in Bulgaria* was presented in May. The priorities and vision for attracting certain investors are based on profound analysis of the national economy strengths and weaknesses and on global trends that will affect investment flows over the next 10 years. The priority sectors identified in the strategy (electronics and electrical engineering, information technology and outsourcing, biotechnology, pharmaceuticals, organic farming and spa tourism) have been identified in previous documents as such with higher value added and export potential, but the current analysis is based largely on long-term global trends associated with the increased significance of “green” technologies and promotion of renewable energy resources. The country should benefit from those trends, as investment in such areas can create the basis for sustainable economic development. Changed conditions after the crisis suggest applying a more aggressive approach and proactive marketing to attract investors in priority sectors, as the investment boom of 2006-2008 will not be repeated. The big problem is that without strong political will, consensus and public support for serious and quick reforms in education, administration or the judiciary (areas creating barriers to investors) the Strategy will be just another illustration of yet another thorough analysis and good intentions with no result.

Problems persist in relation to **public procurement** awards and executions. These problems are included in the above assessment of the EC. Cooperation among different administrative bodies responsible for implementing different aspects of legislation on public procurement is weak, and judicial authorities are unable to protect procurement from conflict of interest. It also highlights that internal procedures approved by various institutions in public procurement do not enable efficient identification and protection against conflict of interests, and the preventive effect of the specific administrative punishments is insufficient.

Amendments are expected in legislation on public procurement. In early June this year the Council of Ministers approved a draft **Law Amending the Law on Public Procurement**. The document has been developed in pursuance of the Concept for changes in legislation on public procurement in 2011, adopted by the Government on January 12, 2011. Its purpose is to simplify legislation in the sector, easing the procurement process and improving preliminary control procedures on contracts financed by EU funds.

At the end of April 2010 a cooperation agreement was signed among the National Audit Office, the Commission on Protection of Competition and the Public Financial Inspection Agency. The

three institutions will interact in executing control on public procurement and in identifying and preventing violations of the Law on Protection of Competition in the so called "collusive bidding."

Fight against corruption. The published in late July *EC report on the progress under the Cooperation and Verification Mechanism (SMEs)* notes existing political will and commitment of the Bulgarian Government to continue implementation of the reform strategy. Bulgaria is pursuing reforms in the judiciary, strengthening legislation on the conflict of interest and has begun structural reforms in the police and the criminal courts. However, the report notes that in the last twelve months the fight against high level corruption did not lead to final results and the overall result of the fight against organized crime should be substantially improved. The governance in the judiciary has still to show its real commitment to judicial reform.

Significant improvements in the accountability and professional practice of the judiciary and investigation are needed for positive results in the fight against corruption and organized crime. It is important to achieve real improvements in recruitment, assessment and skills of the judiciary and to build efficient structures for hearing the cases related to organized crime. The adoption of a new law on asset forfeiture will be important for better protection against organized crime and corruption.

The immediate and continuous implementation of the strategy for judicial reforms, and taking further action on fundamentally reforming the judiciary, should be Bulgaria's national priority. The report includes several specific recommendations to the country for improving the judiciary and fighting corruption and organized crime.

Privatization and concessions. The government is active in accelerating the processes of privatization and concession of state share companies. One step is related to *selling stocks and shares of companies with state participation*. Contract was signed with the company selected for the sale of state shares in "E.ON Bulgaria Sales "AD (33%) and" E.ON Bulgaria Grid "AD (33%). In May 2011 the Agency for Privatization and Post Privatization Control initiated a competition for the selection of investment brokerage company to sell 33% of the capital of "CEZ Distribution Bulgaria" AD, Sofia and 33% of the capital of "CEZ Electro Bulgaria" AD, Sofia. Competition procedure was announced simultaneously for selecting an investment company for selling 33% of the equity in "Distribution EVN Bulgaria" AD Plovdiv, and 33% of the capital of "Electricity EVN Bulgaria" AD Plovdiv. Shares of the companies will be listed on "Privatisation market" of "BSE – Sofia." On June 22, 2011 the Agency for Privatization and Post Privatization Control announced the selected participants and winners for selling EVN and CEZ minority packages. "Central Cooperative Bank" AD, Sofia will be the broker for selling 33% of "CEZ Bulgaria," Sofia and 33% of the capital of "CEZ Electro Bulgaria," Sofia. "Bulbrokers" EAD, Sofia is the investment company for selling 33% of the shares in "EVN Distribution Bulgaria" AD, Plovdiv and 33% of "Electricity EVN Bulgaria" AD, Plovdiv.

BNB Governing Council decided in May 2011 to transfer the ownership of bank shares of "Central Depository" AD to the Ministry of Finance. Decree was approved to fund from the Ministry of Finance budget the acquisition of 20 percent share of BNB in the capital of "Central Depository" AD. This consolidates the state participation in the company and implements the adopted by Government Concept for integration of "Bulgarian Stock Exchange" AD and "Central Depository" AD into European and global financial markets. The government plans to implement a single privatization procedure for the sale of state shares in both companies.

The Agency for Privatization and Post Privatization Control announced the method for selling "Bulgartabac Holding" AD – through publicly announced one stage tender for 5,881,380 shares,

which are approximately 79.83% of the capital. The remaining 20.17% are owned by private shareholders.

The Government initiated amendments to the *Law on Privatization and Post Privatization Control*, in order to include on the list of companies prohibited for privatization two companies with majority state ownership "Fish resources" EOOD and "National Palace of Culture - Sofia Congress Center" EAD, on the grounds that they are of strategic importance to the national economy and of great significance to the public.

Bulgarian State Railways are facing financial and organizational problems, which require urgent restructuring and reorganization of the company. To meet the requirements of the World Bank related to loans to the company, the management of Bulgarian State Railways will put for public debate a Plan for restructuring and financial stabilization of the company. Part of this plan is related to possible future privatization of freight transport.

The Parliament adopted the amendments to the *Law on Concessions*, which regulates the legal possibility municipalities to manage for free mineral waters in their territories for a period of 25 years. In 2010 with the adoption of the Water Act, the Parliament provided for municipalities to dispose mineral water sources, which are exclusive state property and are not conceded. Until now the change was not regulated by the law.

PUBLIC FINANCES. At the beginning of the second quarter the good performance of the indicators over the same period of 2010 is still continuing. The total balance as of May is a deficit of BGN 600 million, which is twice lower than that of the five months of the previous year.

Consolidated revenues are still above their previous year levels, accumulated by May are by 6.8 % above those of May 2010. Increase in revenues over their levels in 2010 is mainly due to accumulated revenues from VAT and excise duties, rising correspondingly by 18% and 17.8%. Although there is certainly some recovery in economic activity in Bulgaria the growth in revenues from VAT on domestic transactions and excise taxes is greatly due to inflation in food products, alcoholic beverages and tobacco, transport and fuels in the first five months of 2011.

Accumulated costs in the first five months are still below those in the same period last year, but show decreasing decline - 10 % in February and 1.2% in May. This results to a great extent from a seriously slower contraction of current maintenance, which as of May is only 0.6% below its previous year. The annual decline in wages is 3.3% in May compared to 8.7% in March, and capital expenditures - 26.6% compared to 47.4% in March. This is due to a serious increase in monthly spending in April and May over a year earlier, in all three groups.

The budget deficit for the five months of the year is 31.5% of the government objective. This good news, however, is spoilt by the slowing decrease of spending decline which is somewhat due to the low base in April and May 2010, but pre-election spending may be expected. Judging by recent parliamentary elections this phenomenon starts 3-4 months before the vote. The effect is accompanied by promises for additional spending by the end of the year - increase of minimum wage, widows' pensions, spending on infrastructure and others.

Along with this, the NRA announces expectations for revenues of BGN 500 million lower than expected for 2011, which include BGN 300 million proceeds from insurance. The overall impact of lower revenue collectibility and the unexpected growth in costs by year-end question the achievement of 2011 fiscal targets.

Maintaining the levels of most of the direct taxes unchanged in 2011 provides better economic conditions for recovery in the last two years of recession. The situation is different in contributions

which are actually increased since the beginning of the year. The increase in pension insurance clearly has a negative impact on the private sector, where besides the decline in employment there is a parallel contraction in new jobs. The early increase of excise duty on diesel, kerosene and tobacco also seems unreasonable, especially given the increasing oil prices on international markets.

Government spending in the country is among the most inefficient in the EU, and before considering on increase of various levies, the quality of public spending should be improved. This is even more so given the fact that the state budget has serious structural problems that despite the crisis of the past two years are not resolved yet.

SOCIAL AND HEALTH POLICY. After long and active discussions, between government, employers and trade unions on the need and possibilities for increasing the minimum income, it was decided to increase the minimum wage from BGN 240 to 270, and widows' pension supplements for elderly people living alone, as of 1 September. They are to receive additional 6.5% of the pension of the deceased husband/wife – i.e. in addition to the current 20%. This decision is part of GERB pre-election program, and the whole debate on increasing the minimum income and the decisions create to some extent the impression of campaign gesture to the electorate. However, objective conditions which require for adjustment of the minimum income and the need for a comprehensive policy are also present.

The decision for increasing minimum income is not expected to lead to increase of planned budget deficit, due to deferring it in time, and due to the government's intention to adhere to prudent fiscal policy. The impact of increased minimum wage on the labor market will be rather positive, since it will limit opportunities for the informal sector in certain industries to save on taxes and insurance at the expense of loyal employees.

The impact of the presidential and local elections in the autumn is strongly felt in healthcare. We are witnessing conceptual differences between the institutions responsible for healthcare reform, and general indecisiveness - postponing changes for no reasons. It is clearer that health reform is not a priority for the ruling GERB party and is unlikely to become such till the end of its term.

FINANCIAL SYSTEM. Bank assets increase during the second quarter of 2011 and by end June reach BGN 24.13 billion which is by 1.5% over the same period last year. Their average value, however, for the first half of 2011 is almost unchanged compared with 2010. Only liabilities to the state have negative impact on foreign exchange reserves, which shrink by an average of BGN 1.6 billion, which is balanced by growth in other groups of BNB assets.

The average value of the monetary base (currency in circulation and deposits of commercial banks in BNB) in the second quarter of 2011 is by 8.8% over the same period last year. Better results are partly due to the increased money in circulation - 3%, but more so due to the deposits of commercial banks, whose average in the second quarter is 17% over the same period last year.

Most major indicators of **the banking system** - borrowed funds and balance sheet assets improve in the second quarter of 2011, while liquid assets decrease slightly, but remain high. Borrowings grow by 5.6% yoy in May while during the same period a year ago they increased by only 0.7%. Similar is the situation of balance sheet assets on an annual basis with increase by 5.7%, while for the same period of 2010 they increased by 1.8%. Liquid assets amount to 23.93%, down compared to March - 24.45%, but rising compared to May 2010, when they were 21.84%.

Despite the continuing instability, the pace of increase in domestic credit and improvement of banks financial performance is higher. With slowing growth in bad loans and the gradual

stabilization of economic activity, better performance of the banking sector can be expected by the end of the year.

Slowing decline in **the leasing market** continues for a third consecutive quarter, it reaches 18.2 % in the first quarter of 2011 compared to 19% at the end of 2010. The slowing decline in the leasing market is mostly due to loans for trucks and light cargo vehicles, which decrease by 2.5 p.p. more slowly over the last quarter of 2010. The contraction of receivables for machinery and industrial equipment is almost unchanged, and those for automobiles rise slightly.

In the period January - March the increasing contraction trend of the assets of leasing companies was interrupted, it reached 15.3% yoy compared to 17.6% in the previous quarter. The greatest burden comes from loans, which for a third consecutive quarter slow down their decline which reaches 18.7%.

Given the better performance in trade and transport the leasing market can be expected to reach the bottom in the next six months. Depending on performance of construction, which has not yet reached its lowest point, and the dynamics in manufacturing, the recovery of the leasing market can be shifted by end 2011 and early 2012. The dynamics of loans for other services to households will also have an important role for the sector's recovery from the recession.

In early 2011 the rate of decline in earnings in **the insurance market** decreases and in April, they decrease by 1.1% compared to 3.5% in December. Although life insurance premiums continue to shrink year on year – by 1% in April, their performance is much better compared to December 2010, when they decreased by 5.6%. Life insurance also declines - by 1.7% compared to 10% growth in December.

Revenues from basic activities of general insurance companies are only BGN 528 thousand, but the series of losses in the previous two quarters is interrupted. The total profit of the companies amounts to BGN 4.8 million, down 72.5% over the previous year due to lower earnings from basic activities.

Profit from basic activities of life insurance companies significantly decreases in the first quarter and is only BGN 458 thousand, down from nearly 90% yoy. Total profit for the first quarter is BGN 2.1 million, or a decrease of 68% yoy.

The good news is that there is a reversal of the trend for increasing benefits and declining premiums in the sector. The slower contraction in company revenues and the more rapid reduction of paid out benefits is a positive signal. Given that real growth of domestic demand is expected for the first time in 2011 since the recession, and the low base of premiums over previous periods, recovery may be expected by the end of the year.

Capital Market. Most BSE indices return to losses in the second quarter and only BGREIT increases - to 2.22 % compared to the end of March. The other three indices report declines in the range of 5.4% - 7.1%. Besides, the number of transactions on the BSE decreases - in the second quarter of 2011 they are by 44.5 % below their level in the previous quarter.

The blue chip index SOFIX declines by 7.1% for the period April - June and closes at 413.77 points. Its movement in the first half of the period is almost minimal, but in the second half there is a declining trend. The broader index BG40 also reports a downward trend, which for the three months is 5.4%.

Although financial and insurance activities retain dominant position in the sectoral structure of trade on BSE-Sofia, their share declines from 71% in the first quarter of 2011 to 44% in the second. Manufacturing continues to expand its share of 22% and progresses to 25%.

ENERGY. State owned enterprises in the energy sector in general increase their profits significantly in 2010 over the previous year. At the same time most of them report increase in revenues and the trend continues in the first quarter of 2011. The better performance of energy companies is due to higher electricity prices and export growth. Moreover, the majority of companies, whose principal is MEET, report contracted costs on external services.

On June 1, 2011 the National Assembly approved **the Energy Strategy of the Republic of Bulgaria by 2020** – a fundamental national energy policy document. There are five major priorities: security of energy supply, accomplishing the renewable energy targets, energy efficiency, development of competitive energy markets and policies to meet energy needs, consumer interest protection.

In early June MEET presented the main steps for **electric power exchange** concept implementation. After testing the trading platform, the real work of the new market model of the electric power exchange should start in 2012.

In early July, NEC and Atomstroyexport signed Appendix № 13, which extends the duration of the Agreement on **NPP "Belene"** from 2006 to September 30, 2011. Over the next three months both parties will seek answers to questions on technical design and increased safety requirements, for the market analysis by HSBC, as well as work on the contract for the execution, delivery and construction, to be better bank-serviced, to better meet the requirements of potential international investors.

The project pipeline **"Southern stream"** will most likely get the European Commission permission to waive requirement for providing third party access to transit of the raw material. This is a requirement of the third EU energy package, related to energy market liberalization. This derogation will also apply to the gas pipeline "Nabucco" and gas connections and interconnections with neighboring countries.

In June, government representatives from all transit countries (Austria, Bulgaria, Hungary, Romania and Turkey) in the **"Nabucco" project** signed in Turkey agreements of support. This finalizes the legal framework of "Nabucco."

TRANSPORT. In the first quarter of 2011 *goods transported* by **road transport** rise by 34.2% over the same period last year. Increase is observed in both domestic and international shipments correspondingly by 31.3% and 40.5%. Data on **water transport** suggest that in the first quarter of 2011 the amount of *transported goods* is by 10.3% less than the same quarter of 2010. This is due to the smaller cargos transported by sea.

On May 15 2011 MW **"Liulin"** was launched for operation - the first completed motorway in Bulgaria. Construction began in 2007, the total amount for completion of the 19 km road reached Euro 185 million. The construction of three lots of the **"Trakia" Motorway** - from Stara Zagora to Karnobat is on schedule. Procedures were carried and contractors were selected for Lot 1: Orisovo-Dimitrovgrad and Lot 2: Dimitrovgrad-Harmanli of the **"Maritza" Motorway**. The selection procedure for contractor of Lot 1 Dolna Dikanya-Dupnitsa of the **"Struma" Motorway** is completed. The selection for contractor of Lot 4 Sandanski-Kulata is underway. In July, a **Public Committee for Monitoring "Struma" Motorway** was created.

In early July the National Assembly adopted amendments to the **Law on roads**. **National company "Strategic Infrastructure Projects"** is established after the amendments, with main activity – the design, construction, maintenance and repair of motorways "Struma", "Hemus" and "Black Sea."

The implementation of major projects for railway infrastructure improvement is underway. In May the rehabilitation and modernization of **the railway Plovdiv-Burgas** started. In early July contract was signed with selected contractors to modernize **the railway Septemvri-Plovdiv**. A selection procedure is underway for reconstruction and electrification of **the Dimitrograd-Svilengrad railway**.

TOURISM. Visits of *foreign citizens* to Bulgaria in May 2011 increases by 7.1% over the same month of 2010. The biggest increase is registered in visits for holidays, trips and transit travels. Visits of EU citizens increase over the same month last year by 4.3%. The greatest increase is in visitors from Greece and Romania. In May 2011 trips of *Bulgarian citizens* to foreign countries increase by 2.6% compared to May 2010. Revenues from tourism in the period January - April 2011 are Euro 431 million over Euro 408 million in the same period last year. Data show increased revenues from tourism which is optimistic, and it is the basis for a favorable outlook for the sector this year. Spending of Bulgarian citizens on travels abroad increases.

Expectations for the summer season are optimistic - experts predict increase in the number of tourists by about 10%, and this will be the largest increase in recent years. Most significant increase is likely to come from Russian tourists - about 30%. Positive are the expectations for mass and alternative tourism - cultural, rural, wine, spa and religious tourism. The summer season will be strong for Bulgaria with significant impact from the advertising campaign promoting the country as an attractive tourist destination, which MEET funded under Operational Programme "Regional Development." The optimistic expectations are based on several assumptions. First, prices stop falling. Until last year, hotel owners and tour operators were constantly pressed for significant price discounts in order to attract tourists. This is no longer observed now – there is stability, and price levels increase. The second prerequisite for a good season is the revival of different countries' economies. Charter flights from Russia and Germany increase over last year – and they are Bulgaria's main markets. The next indicator for a better season is the volume of early bookings and the volume of bookings, which is higher by about 30% compared to last year.

The adoption of new **Law on Tourism** is forthcoming. One of the main provisions of the Law provides the tourist tax to remain entirely within municipalities and to be used solely for tourism purposes. The regulation that 30% of the tourist tax should go to the government will be abolished. The decision was taken after meetings with the National Association of Municipalities and expresses the government will for decentralization. There is still a discussion on whether separate **Ministry of Tourism** is needed, more so in some strategic documents (National Development Programme) tourism is defined as a priority sector. Tourism experts consider greater attention to tourism as imperative, since it is among the few revenue-generating businesses in recession.

AGRICULTURE. The growth of agricultural production in the first quarter of 2011 reaches 8.8% yoy. Its share increases in GVA and GDP – correspondingly by 3% and 2.6% (2.8% and 2.5% a year earlier). This is due to the good harvest, rising food prices, and high demand worldwide. Relatively favorable agro-meteorological conditions provided for good grain harvest this year. About 600-700 thousand tons of barley and nearly 4 million tons of wheat are expected to be harvested. The quality of grain is estimated to be better than last year, manufacturers expect starting price no less than BGN 300 per ton of wheat. Spring crops show good development - areas cultivating maize and sunflower are more than last year, unless weather conditions worsen, they

will produce good yields. Thus the sector will not only continue to demonstrate high export potential, but will become more attractive to investors. Unfortunately this makes more obvious the old, familiar problems of land fragmentation, outdated equipment, lack of irrigation systems, clumsy and inefficient administration of payments, which prevent efficiency and profitability increase of agricultural production. In order to realize the great potential of agriculture there is a need for consistent policy, clearly defined priorities and adequate support, long-term planning, adequate infrastructure, modern equipment, absorbed advanced technologies as well as innovative farmers, capable of developing new market niches.

Since the beginning of the year, State Fund "Agriculture" has paid farmers BGN over 1 billion subsidies under various schemes. Many experts believe that subsidies contribute to keeping current inefficient structure of agricultural production in the country, and prevent its reform. Maybe the decision will come with the changes in the Common Agricultural Policy 2014-2020. The announced debate positions differ a lot, but it should be clear in the autumn what ideas are common for most member states. The problem is not only the large share of funds for agriculture in the total EU budget (40%), at the expense of areas such as science and innovation, for example. Allocation between the existing two-pillar – direct area payments and investments in rural development – is also put to debate. Solutions are sought for equitable distribution of payments by eliminating the historical approach, under which new member states are disadvantaged. One of the key reforms of the new CAP will undoubtedly be the further promotion of environmental policy by subsidizing only environmentally friendly projects. Future development of agriculture in our country will depend on this final decision.

REGIONAL POLICY AND EUROPEAN FUNDS. The implementation of operational programs continues - as of May 2011 Euro 3,678 million have been contracted of the total EU budget of Euro 8,019 million for Bulgaria, and Euro 998 million have been paid. This means that over 45% of the total financial resources from European funds are contracted and absorption of resources reaches nearly 12%. Under programs "Transport" and "Regional Development" over 50% of the amounts have been contracted. Under programs "Competitiveness" and "Administrative capacity" payment is over 20%, and under "Regional Development" - 15%. There is progress under program "Environment" - 142 projects are implemented, Euro over 487 million are contracted. Nine infrastructure projects are completed - 6 water and sewage systems, and 3 water purification stations.

Specifically under the "Regional Development," with total budget a little over 3 billion euro by 2013, projects for Euro 1.7 billion have been approved for funding, which is 55% of the program budget. In the coming months the amount of approved projects is expected to grow by another Euro 400 million. Evaluation procedures of submitted projects are carried out. During the summer the last projects will be considered, under which the rehabilitation of roads in the country will be funded. So far projects for nearly BGN 430 million under "Regional Development" have been paid, which is 15% of the program budget.

According to a report of KPMG auditing company, of the ten new EU member states, Latvia has utilized most of EU funds. Bulgaria ranks last. Despite the increased absorption of funding, an analysis of the EU in the first quarter of 2011 indicates low level of absorption in Bulgaria compared to other countries. As of April 1, 2011, of the 27 EU member states, Bulgaria takes 24-th position in absorption of the European Regional Development Fund, 25-th position in the absorption of the Social Fund and the last position in the absorption of the Cohesion Fund. Particularly alarming is the situation with funds under Environment. Bulgaria may lose EU funding here. Rapid measures and accomplishment of positive results are a must.

Representatives of the business in the country strongly criticize the implementation of Operational Programme "Competitiveness." This has forced the government to open the next scheme, to implement a package of measures simplifying application process. **The electronic application** for projects under "Competitiveness" and "Human Resource Development," which affect numerous beneficiaries, has been introduced. The mechanism will be applied to program "Administrative Capacity" as well. The aim is EU fund management to be carried electronically in the next programming period 2014-2020.

Bulgaria is expecting to receive 10-15% more resources from EU funds in the next program period. The next 18 months, while budget negotiations are going, it will be extremely important that the country demonstrates its readiness to absorb the funds, in order to turn these preliminary figures recorded in the EC's proposal, into reality. The EC may increase direct payments to farmers in Bulgaria by 70% and 30% of the subsidy will be granted only on the condition that they develop organic agriculture.